SUSTAINABLE REAL ESTATE SOLUTIONS™

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TO:	Committee on Energy & Technology
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REGARDING:	Written Testimony for the Establishment of a Commercial Property Assessed Clean Energy (PACE) Program

Background

For several years, it has become increasingly evident to stakeholders in commercial real estate (CRE) that building energy performance can impact property value. As a result, less energy efficient buildings are now viewed as having a competitive disadvantage in the market and may be in danger of accelerated obsolescence. The result has been a growing number of retrofit projects designed to increase building energy efficiency, particularly when energy-using equipment needs to be upgraded or replaced.

The CRE market, consisting of almost five million office, retail, service, lodging, multifamily, warehouse and storage buildings in the U.S., represents a significant opportunity for building stakeholders to reduce energy use and monetize their energy savings. Almost three quarters of these buildings were constructed prior to 1990, with many still relying on original mechanical and electrical systems that are at or near the end of their useful lives.

In CRE, the high frequency of ownership turnover can discourage certain energy savings retrofit projects because the resulting payback period can be longer than the anticipated ownership term, and there is concern that the investment may not be recouped on sale. Also, many buildings in the CRE market are not owner-occupied, but rather involve multi-party leases under various lease structures (often triple net leases). This may mean that most, if not all, the energy savings generated by improving building operations benefit the tenant, and may not benefit the owner enough to make a compelling investment case.

The lack of commercially-attractive funding has been a major impediment to energy efficiency investment in the CRE market today. In a recent survey, McGraw-Hill found that energy efficiency retrofit projects more often than not rely on internal balance sheet resources, rather than outside funding. This represents a potential obstacle where capital budgets and corporate profits are under intense pressure due to the current economic environment. As such, energy efficiency investments may need to compete for a company's limited pool of capital with other competing priorities.

There is no question that commercially-attractive financing needs to be more readily available to support market growth in the CRE energy efficiency sector. To accomplish this, innovative financing mechanisms, including Property Assessed Clean Energy (PACE) Programs have been developed over the past few years that will significantly accelerate energy efficiency financing in the CRE market.

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Accelerating Energy Efficiency Financing in the CRE Market

Most of the low cost improvements with relatively short payback periods and low risk are being, or have already been implemented. As a result, the CRE industry is moving from the installation of lower cost, short payback (less than 2-3 years) energy efficiency improvements to figuring out how to handle deep retrofits where the capital need is much more intensive and the payback period longer. The challenge is how to deal with these deeper, more capital intensive energy efficiency retrofit improvements, particularly when internal financing is scarce or not available.

To accelerate energy efficiency improvements and enable CRE stakeholders to unlock the full potential for monetizing energy savings opportunities, the ideal "commercially attractive" financing mechanism allows for the following:

1. Funding of the project without any capital expense;
2. Funding that does not add debt to the property;
3. Funding that covers 100% of the project cost, including upfront costs and both hard and soft costs, i.e., no "out-of-pocket" owner expense;
4. Funding structure that results in favorable tax treatment for expense, i.e., that will be tax deductible to the maximum extent possible;
5. Funding that will be at relatively low cost and payable over an extended period of time, i.e., 10 to 20 years. This will allow energy savings to offset the investment necessary to capture the savings, decrease operating costs and achieve cash flow positive status immediately.

Property Assessed Clean Energy (PACE) Programs

PACE programs, also referred to as tax-lien financing, allow local governments, when authorized by state law, to fund energy improvements on commercial and industrial properties via an additional assessment on the property tax bill for a lower cost of capital over a long term (typically 10-20 years). PACE financing also transfers with sale of the building so that future owners or tenants assume the payments but at the same time receive the savings benefit.

In addition to local government funding, financing can also be provided by private investors. For example, in the "private placement" (or "owner arranged") PACE model, the municipality acts as a conduit for private investment. Individual property owners negotiate financing terms with investors of their choice. The owner-negotiated terms are then reflected in a loan agreement funded, for example, through issuance of a bond which is then sold to the investor that underwrote the deal. Financing is repaid as a line item on the owner's property tax bill, which can make both the energy savings and the cost to achieve these savings a pass-through to building tenants. The repayment obligation transfers with ownership. The Los Angeles Commercial Building Performance Partnership program, a potential bellwether program designed to stimulate CRE energy efficiency investment, uses this PACE model.

There is also a "bond" PACE model that involves the issuance of bonds to create a local or state fund that the local government will then make available to the PACE program. The Florida PACE Funding Agency relies on this model.

Lastly, there is the "warehouse" PACE model where an investor makes available a line of credit for the cities and counties to use in funding the PACE program, with the intention of reaching a critical mass of funding that results in bonds or other securities issued in order to replenish the line of credit. The PACE Commercial Consortium (PCC) created by Carbon War Room with Ygrene Energy Fund is an example of this type model. Barclays has committed to short term financing (and warehousing the loans) for its first projects in the Miami and Sacramento areas. When critical mass is reached, Barclays plans to bundle the loans into long term bonds resembling those routinely issued by government taxing districts and market them.

In PACE programs, the loan is secured by a lien on the owner's property and is paid back via a charge on the owner's property tax bill. PACE assessments may be eligible for "expense pass throughs' to tenants as operating expenses under existing leases. In the case of net lease agreements where tenants are responsible for utility costs, the pass-through of the PACE assessment allows owners to both implement projects and equitably share project costs with tenants who benefit. Municipal loan pools are funded by issuing bonds and/or with state/federal grant funding. The mortgage holder's consent is required before applications are approved and assessments placed. With PACE programs, by significantly expanding the term of the typical energy efficiency loan (to 10-20 years), it often becomes much more likely to have the reduced monthly energy bill (the energy savings) more than offset the additional charge (for loan repayment) on the monthly property tax bill and therefore achieve cash flow positive status immediately. To date, 27 states and the District of Columbia have passed enabling legislation enacting PACE programs, with more than a dozen commercial PACE programs either actually in operation or far along in the development process.

Conclusion

PACE programs leverage a familiar municipal finance tool that has been used successfully for decades to finance water and sewer projects, among others. The PACE program structure whereby a voluntary senior tax lien is placed on the property in order to secure financing for the energy retrofit project is a critical financing mechanism to help overcome the key barriers to CRE energy retrofits such as the owner's limited access to capital, short-term focus and the split incentives between owners and tenants.

Furthermore PACE will provide the state of CT CRE stakeholders (building owners, contractors, municipalities, lenders) with a commercially-attractive energy efficiency financing mechanism with a high degree of standardization, predictability and scale. The result will be large scale adoption of energy efficiency investment in the CT CRE market that will unlock the full-potential of the significant benefits to our state:

1. Job creation – particularly in the hard-hit construction trades to install energy retrofits;
2. Attract private capital – PACE requires NO government subsidies or increased taxes;
3. Reduces owner energy costs – lower energy costs also increases buildings value;
4. Lowers carbon emissions – helps achieve carbon reduction goals;
5. Energy Independence – CRE buildings account for ~ 20% of our energy use and represents the largest near term energy conservation opportunity;
6. No state budget impact – voluntary CRE stakeholders pay all fees.

In sum the passage of a CT CRE PACE program will provide the foundation and vehicle to a win-win solution for all CRE stakeholders and CT municipalities.